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Chief Administrative Officer

February 22, 2005

To: Supervisor Gloria Molina, Chair
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From: David E. Janssen
Chief Administrative Officer

SACRAMENTO UPDATE

LEGISLATIVE ANALYST'S OFFICE (LAO) REPORT: <u>THE 2005-06 BUDGET: PERSPECTIVES AND ISSUES</u>

On January 10, 2005, Governor Schwarzenegger released his FY 2005-06 Budget proposal to close a $9.1 billion budget gap, including funding for a $500 million reserve. Today, the LAO released the first of a two-part analysis of the Governor's proposal, The 2005-06 Budget: Perspectives and Issues (P&I), which contains an overview of the economic assumptions, revenue projections, and major expenditure proposals in the Governor's budget, as well as a discussion of the major issues it poses for the Legislature. On Thursday of this week, the LAO will release its detailed analysis of the Governor's Budget. Attached is a summary of the P&I. The complete report is available at http://www.lao.ca.gov/analysis_2005/2005_pandi/pandi_05.pdf.

The basic message of the LAO's report is that the Legislature faces an "important budget opportunity" toward solving the State's chronic, structural budget problem. The opportunity arises because of the fact that the LAO projects an additional $2.4 billion in revenue not anticipated in the Governor's budget which, if coupled with the roughly $5 billion in ongoing savings contained in the proposed budget, would assure a balanced budget in FY 2005-06 and provide a solid reserve to reduce the projected budget gap for FY 2006-07. What the LAO may be concerned about is that the new revenue could be combined with the unused proceeds from the Economic Recovery Bonds to eliminate the need to make any reductions in the budget year. Such an outcome would push the entire $9 billion structural deficit into FY 2006-07 and simply postpone the painful decisions for another year.

The Economic/Revenue Outlook

The LAO and the Governor are in basic agreement on the key assumptions about economic growth that drive the revenue forecast for the budget year. However, the LAO, based on the year-end corporate estimated tax filings, and January estimated personal income tax payments which were not available to the Governor when he developed his budget proposal, is projecting $1.4 billion in additional revenue in the current year, and an additional $800 million in the budget year. Most of the gain is from the personal income tax and the LAO believes the growth is largely a result of stock-market-related capital gains and business income gains, both of which are cyclical in nature, which no doubt adds to the caution with which the LAO is approaching the potential use of this new revenue.

State Expenditures

In addition to the increased revenue, the LAO projects that spending in the current and budget years will be $256 million less than expected, primarily because increases in local property taxes will reduce the required State Proposition 98 funding. Total spending would increase to $109 billion in FY 2005-06, including $85.7 billion from the General Fund and $23.3 billion from special funds. Overall General Funds spending would increase 4.2 percent, largely in response to changes in caseload and utilization for major programs, and despite significant reductions in selected areas.

The Governor's Budget Solution

The table below summarizes the proposed solutions in the Governor's Budget.

Proposed Solutions in 2005-06 Governor's Budget
(In Millions)

Program Savings	
Proposition 98	$2,284
Social services grants	714
Employee compensation	408
Non-education mandate suspensions	219
IHSS wage participation	195
Senior citizens' tax assistance	141
Other	599
Subtotal, Program Savings	$4,560
Funding Shifts	
Increased school contribution to STRS	469
Retain PTA spillover in General Fund	216
Federal funds for certain prenatal care	191
Other	93
Subtotal, Funding Shifts	$969

Loans [a]	
Deficit financing bonds	1,682
Proposition 42 suspension [b]	1,310
Judgment bond for *Paterno* lawsuit settlement	464
Mandate deferral	31
Subtotal, Loans	$3,487
Revenues	
Increased tax compliance	77
Total	**$ 9,093**

[a] In addition to these totals, assumes $765 million in proceeds from pension-obligation bonds authorized in 2004-05 budget.

[b] The administration indicates this is treated as a loan in its debt consolidation proposal.

As can be seen, approximately one-half of the solutions are from program savings, with half of those coming from K-14 education. Almost 38 percent of the remaining solutions are the result of loans, with most of the balance from fund shifts. Revenue solutions are negligible, the result of an increased effort to collect existing taxes.

The LAO estimates that approximately $4 billion of these budget solutions are ongoing in nature and will increase to some $5 billion in FY 2006-07 when the full year impact is felt. As a result, over one-half of the projected $9 billion operating deficit in FY 2006-07 would be eliminated. In addition, if the $2.4 billion in additional revenue now projected remained unspent and became part of a $2.9 billion budget reserve, the reserve plus some $2 billion remaining in Economic Recovery Bond authority would erase the operating deficit projected for FY 2006-07. However, since the reserve and the bond proceeds are one-time revenues, a $5 billion operating deficit would reemerge in subsequent years. The LAO notes that amount could be reduced by roughly $1 billion as a result of the Governor's proposal to consolidate all the State's outstanding obligations related to transportation, education, local governments, and special funds, and stretching out their payment over 15 years.

In concluding the analysis of the State's fiscal picture, the LAO cautions the Legislature to aim for ongoing solutions similar in magnitude to the Governor's proposals to make the out-year budget problem more manageable and to be cautious about the Governor's budget reform proposals which the LAO believes go in the opposite direction from what is needed to accomplish the Governor's stated objective of reducing the amount of spending that is on cruise control.

Major Issues of Interest to the County

The LAO discusses a number of major issues that the Governor's Budget presents for the Legislature, including some of interest to the County. They are summarized briefly below.

Public Employee Pensions: The LAO suggests that there are less drastic alternatives to addressing the high costs and perceived problems of current defined benefit plans short of replacing them with a defined contribution plan, including changing the current plan, creating a hybrid plan consisting of both types of plans, or adopting a cash balance plan. The LAO focuses on the State plan because that is where the potential State savings exist. The LAO notes that while the Legislature has authority over the structure of local government plans, it may wish to consider allowing "local governments to retain the retirement programs they have, at their discretion and responsibility, instead of being required to implement changes." However, they may wish to apply certain specific changes to all plans, including those of local governments.

Suspension of State Mandates: The LAO has a number of issues with the Administration's proposal to suspend, revise, or defer funding for mandates relating to major programs, including mental health services for special education students, absentee ballot administration, and the Open Meeting Act. The Administration has provided too little detail as to the rationale or expectations to evaluate their recommendation. Moreover, according to the LAO, Proposition 1A seems to require the State to fund its FY 2004-05 mandate liabilities in the FY 2005-06 budget unless it suspends the mandate in FY 2005-06 or the mandate pertains to employee rights. The Governor's Proposed Budget does not do that, creating a shortfall of $62 million. In addition, the Administration has under-funded by $67 million the cost of the mandates it has not suspended. Of special interest is the LAO's statement that by suspending the AB 3632 mandate for special education mental health services, the Administration has shifted the responsibility for funding these services to schools.

Budget Related Reforms: As noted earlier, the LAO fundamentally disagrees with the Governor's reforms related to Proposition 98 education funding, the budget process and transportation funding, arguing they would create more, not less, "autopilot spending" and fail to instill fiscal discipline. Instead, they suggest building on existing provisions of law, including Proposition 58, to restrict borrowing and create a larger budget reserve, as well as modifying current formula-driven spending.

Transportation Funding: The LAO is concerned about the Governor's proposal to suspend Proposition 42 in the budget year and potentially the following year, and then prohibit the Legislature from ever doing so again. Too little information has been provided about the impact on transportation projects in the short term, while too little consideration has been given to the need for General Fund budget flexibility in future years. Instead, the LAO revisits its earlier proposal to repeal Proposition 42, raise the gas tax by six cents to raise equivalent revenue, and index the tax to inflation in future years. The resulting revenue would be constitutionally dedicated to transportation and over a billion dollars would be freed up for the General Fund.

We will provide a summary of the LAO's Analysis of the Budget Bill when it becomes available on Thursday.

We will continue to keep you advised.

DEJ:GK
MAL:JR:ib

Attachment

c: Executive Officer, Board of Supervisors
County Counsel
Local 660
All Department Heads
Legislative Strategist
Coalition of County Unions
California Contract Cities Association
Independent Cities Association
League of California Cities
City Managers Associations
Buddy Program Participants

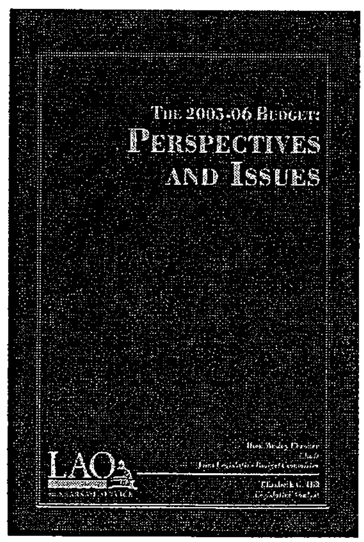
Attachment

February 22, 2005

LAO
60 YEARS OF SERVICE

Highlights of the: 2005-06 Perspectives & Issues

ELIZABETH G. HILL • LEGISLATIVE ANALYST



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Acknowledgments

The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

LAO Publications

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This report and others, as well as an E-mail subscription service, are available on the LAO's Internet site at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.

PART I—STATE FISCAL PICTURE

- The Legislature has an important budget opportunity. We project that revenues are $2.2 billion higher (for the current and budget years combined) than reflected in the Governor's budget. This, combined with the magnitude of ongoing solutions proposed in the budget plan, would result in a balanced 2005-06 budget with a solid reserve.
- However, the price of inaction is significant. Without the adoption of ongoing solutions of the magnitude offered by the budget plan, the 2005-06 budget would be precariously balanced and the state would experience major budget shortfalls in 2006-07 and beyond. These shortfalls would be close to $10 billion.

PART II—PERSPECTIVES ON THE ECONOMY AND DEMOGRAPHICS

- The California economy is expanding at a healthy pace in early 2005, as evidenced by real estate construction, exports, company reports of sales and profits, and business-related tax receipts.
- The one area of concern remains jobs, which are lagging due to intense focus on cost cutting and efficiencies.
- We project the California economic expansion to continue at a moderate pace, with personal income expanding by roughly 5.6 percent and jobs growing 1.5 percent annually during the next two years.

PART III—PERSPECTIVES ON STATE REVENUES

- The current strength in the economy is translating into solid growth in receipts from the state's taxes—particularly the corporate tax and personal income tax.
- Recent cash receipts trends have been even stronger than anticipated in the Governor's budget, mainly because of strong 2004 year-end collections from the personal income tax and corporation tax.

- Based largely on these positive trends, we project that General Fund revenues will exceed the budget forecast by $1.4 billion in the current year and $765 million in the budget year.

PART IV—PERSPECTIVES ON STATE EXPENDITURES

- The budget proposes total state expenditures of $109 billion in 2005-06. This includes $85.7 billion from the General Fund (up 4.2 percent from the current year) and $23.3 billion from special funds (up 5.3 percent from the current year).
- The overall General Fund spending growth rate reflects (1) changes in caseloads and utilization for major programs; (2) the impacts of the Governor's savings proposals; and (3) the impacts of numerous other special factors, such as one-time savings in the 2004-05 budget.
- The proposal includes about $3.5 billion in new budgetary borrowing related primarily to deficit-financing bonds, a judgment bond, and Proposition 42 suspension. This brings the total amount of budgetary borrowing outstanding to about $29 billion as of the end of 2005-06.

PART V—MAJOR ISSUES FACING THE LEGISLATURE

➢ **Governor's Budget-Related Reforms**

- In this piece, we review the Governor's budget-related constitutional reforms.
- Our main conclusion is that the Governor's proposals put more spending on autopilot and would make it more difficult to balance future budgets in a rational way. The changes would also result in a diminution of legislative authority.
- The aim of potential reforms should be on increasing the tools and flexibility available to policymakers for dealing with changing budgetary circumstances. Specific options include (1) strengthening reserve provisions of Proposition 58 and (2) "unlocking" the budget by modifying existing provisions in law that earmark spending.

(Contact: Brad Williams, 319-8306)

Addressing Public Pension Benefits and Cost Concerns

- California "defined benefit" pensions in the public sector raise certain benefits and cost issues. For instance, some formulas provide retiree benefits that equal their working income. In addition, governments are "on the hook" for all increased retirement system costs. In response, the Governor proposes shifting all new public sector employees to "defined contribution" plans. Defined contribution plans address concerns with defined benefit pensions, but also introduce issues of their own. The Legislature could also address the benefits and cost concerns of current retirement plans within the existing defined benefit structure or with other pension plan alternatives.

  (Contact: Michael Cohen, 319-8310)

Assessing the Governor's Reorganization Proposals

- On January 6, 2005, the administration released its plans to eliminate 88 boards and commissions and to reorganize the Youth and Adult Correctional Agency (YACA). For each of the plans, we provide an assessment of its fiscal effect and raise key issues. Although the administration recently has decided not to forward its boards and commissions proposal to the Legislature, the piece provides key considerations for the Legislature when seeking to consolidate these types of entities. Regarding the YACA proposal, we conclude it has the potential to improve the efficiency, accountability, and effectiveness of the state's prison system. However, the plan omits important details that the Legislature requires in order to fully evaluate its merits. Our analysis indicates that the proposed reorganization would probably result in net costs in the short term, but has the potential to achieve significant long-term net savings by placing a greater emphasis on inmate rehabilitation as a means of increasing public safety.

  (Contact: Michael Cohen for Boards, 319-8310, and Greg Jolivette for YACA, 319-8340)

Transportation Funding Instability Continues

- The administration proposes to suspend $1.3 billion in Proposition 42 transportation funding and to reduce the General Fund's commitment to repay transportation loans in the near term. This would help the General Fund condition but restrict already limited transportation funding and increase near-term funding uncertainty. We recommend that the administration provide information to clarify (1) the effect of the Governor's proposals on the size of the transportation program and (2) Traffic Congestion Relief Program funding requirements in 2005-06.

- The administration also proposes to prohibit the suspensions of Proposition 42 after 2006-07. This would increase transportation funding stability in the long run. However, this stability would be lessened by another administration proposal that General Fund expenditures, which include Proposition 42 funding, be cut across the board under certain circumstances. In order to provide long-term transportation funding stability while freeing up General Fund revenue for other purposes, we continue to recommend (1) the repeal of Proposition 42, (2) an increase of the gas tax to generate an amount of funding equivalent to Proposition 42, and (3) adjusting the gas tax for inflation.

  (Contact: Dana Curry, 319-8320)

➢ Toll Bridge Seismic Retrofit: Hard Decisions Before the Legislature

- The administration recently estimated the toll bridge seismic retrofit program requires an additional $3.2 billion to complete and has recommended changing the Bay Bridge's design to save money. The Legislature faces two key decisions: (1) whether to approve a redesign of the Bay Bridge east span and (2) how to fund the program's completion. Redesigning the Bay Bridge could save money, but also raises the risk of cost and schedule increases that could more than offset the savings. As regards the funding issue, we recommend that support be provided by both state and local sources. The Legislature has several options regarding the sources used and the amount to provide from each.

  (Contact: Dana Curry, 319-8320)

➢ Water Policy Issues Facing the State

- The state oversees about 1,600 miles of levees that are aging and deteriorating. Should these levees fail, the state would face a major liability. We analyze and make recommendations regarding the strategies proposed by the administration to address various flood management problems identified in a recent Department of Water Resources White Paper. Our recommended legislative steps include actions to evaluate the structural integrity of the state flood control system, enact a flood control benefit assessment, re-evaluate the state's role with respect to Delta levees, and reduce the likelihood of ill-advised development approvals in flood-prone areas.

- The CALFED Bay-Delta Program (CALFED) is at a funding crossroads given that its primary funding source in recent years—state bond funds—is running out at the same time as the program is projecting $6.3 billion of unmet funding requirements over the next ten years. The program's oversight agency—the California Bay-Delta Authority—has recently approved an $8.1 billion ten-year finance plan for the program that assumes major new sources of federal funds, unidentified state funds, and water user fees. Given that some of the revenue assumptions underlying the plan appear unrealistic, the Legislature will need to establish its expenditure priorities for CALFED so that the program can be "right sized" consistent with those priorities.

  (Contact: Mark Newton, 319-8323)

➢ Evaluating the Administration's California Rx Proposal

- The Governor's 2005-06 budget plan includes a funding request and related legislation for a new state program to help low- and moderate-income Californians purchase prescription drugs at discounted prices. Our analysis indicates that the Governor's plan for drug discounts for the uninsured provides a reasonable starting point for the development of such a program. However, we propose, among other changes, that in the event that drug makers fail to make good on their promises for significant price concessions, an automatic trigger would phase out the proposed voluntary approach, and be replaced by an alternative strategy likely to result in greater discounts on more drugs for consumers.

  (Contact: Dan Carson, 319-8350)

➢ Lowering the State's Costs for Prescription Drugs

- Our review of the state's $4.2 billion annual purchases of prescription and nonprescription drugs found several deficiencies in the state's procurement process which lead to it paying higher prices than necessary. We offer a number of recommendations to correct these procurement and administrative problems that, if implemented, would generate savings totaling tens of millions of dollars annually. For example, we recommend a short-term fix of increasing collaboration between state drug purchasers in order to share more drug pricing information and a long-term fix of leveraging the Medi-Cal drug formulary to lower drug prices in non-Medi-Cal programs.

  (Contact: Michael Cohen, 319-8310)